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CONVERGENCE PROGRAMME OF LITHUANIA (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The Lithuanian first convergence programme, covering the period 2004-2007, was submitted on 14 May 2004. The programme does not make explicit references to the country's strategy on euro adoption and ERM II membership, although the authorities have indicated on several occasions that they intend to join the euro area soon after accession, which implies early ERM II entry, while keeping all the features of the current exchange rate system.

The programme largely complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[2].

The medium-term macroeconomic scenario depicted in the programme envisages GDP growth to remain robust over the programme horizon, particularly in 2004 and 2005, when it is projected at some 7%. Looking further ahead, growth is expected to slow down slightly to about 6.5% in 2006 and 2007, but stays above potential as estimated by the national authorities. Domestic demand is foreseen to continue as the main driver of growth, primarily led by high investment and private consumption growth. The programme's macro-economic projections and external assumptions until 2005 are broadly in line with the Commission Spring 2004 forecasts, with the partial exception of 2005, when GDP is foreseen to grow at 7.3%, against 6.6% projected by the Commission services. The risk of lower than expected growth over the programme's horizon cannot be ruled out and appears the main threat for the achievement of the envisaged fiscal consolidation plans.

Lithuania's inflation performance has been favourable in recent years. Average annual inflation has remained below 2% since 1999, strongly influenced by exchange rate developments in combination with favourable wage and productivity developments. Higher competition in the telecommunications sector added to these factors, contributing to a negative annual rate of HICP inflation of 1.1% in 2003. The deflationary trend initiated in 2002 is expected to reverse this year, to a large extent due to excise and VAT changes required by accession. Annual average inflation is expected to reach 0.9% in 2004 and progressively pick up to 2.5% in 2007. The litas has experienced a nominal effective appreciation of some 50% since 1999, initially under the peg against the dollar and, since February 2002, under the peg to the euro. Both short-term money market rates and long-term bond yields trended down in the course of 2002 and 2003. Money market rates stabilised last year, broadly in line with developments in the euro area money market, and the short-term interest rate spread to the euro area has remained stable at around 60 basis points since end-2003. The yield spread on long-term government bonds amounted to 55-65 basis points in early 2004.

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[1] This assessment has been carried out on the basis of information available as of 16 June 2004.

[2] The code-of-conduct tables annexed to the programme provide all the required data, with minor exceptions, and also some optional information indicated in the code. Table 4 of the programme on the general government budgetary projections gives an incomplete breakdown of expenditure. In addition, inflation is still reported on the basis on the consumer price index (CPI) although table 1 of Annex requires projections for the harmonised index of consumer prices (HICP). The accounting treatment of the compensations for loss of rouble savings and of the real estate restitutions merits further analysis.

The key objective of the medium-term fiscal strategy defined in the programme is "the approximation to a cyclically balanced general government budget". However, while the targets for the actual general government deficit are set below the 3% of GDP reference value in each year, they are not consistent with a position of close-to-balance during the programme period. In particular, the general government deficit is expected to increase from 1.7% of GDP in 2003 to 2.7% in 2004, decreasing gradually thereafter to 1.5% in 2007. The deficit target for 2004 compares with a target of 2.9% projected in the 2003 pre-accession economic programme (PEP) and the budget for 2004 adopted in December 2003. The targets for 2005 and 2006 remain the same as in the PEP. The programme envisages a rise of the GDP-share of both revenues and expenditure in 2007 relative to 2003. The increase in the revenue ratio, by 2 percentage points, is mostly due to a significant expansion in non-tax revenues. The programme includes no major new policy measures to increase the tax ratio but projects this ratio to rise. The expenditure ratio is foreseen to increase by 1.8 percentage points over the same period, fully due to higher primary expenditure that is expected to be marginally compensated by a decrease in interest payments.

The budgetary outcomes could be worse than projected. In particular, the downside macroeconomic risks highlighted above and the experience with expenditure overruns in the past in response to better-than-planned budgetary outturns in the first half of the year, represent a risk to the envisaged budgetary targets in 2004 and 2005. Therefore, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations, at least in the initial years of the programme.

The general government debt to GDP ratio has declined steadily from 23.8% in 2000 to 21.5% in 2003, following the fiscal consolidation path initiated in 2000, together with more favourable borrowing conditions. The programme projects an initial increase of the debt ratio in 2004 by nearly 1 percentage point, due to the projected increase of the general government deficit in the same year. The ratio is expected to decrease throughout the remainder of the programme period and stabilise at about 21% in 2007.

The programme reviews the government's structural reform programme which focuses on the labour market, pension and health-care. Overall, the presented reforms are ambitious and should improve the quality of the public finances. However, some of them, such as the health-care and pension reforms, may entail significant short-term costs, which are not sufficiently analysed in the programme.

Lithuania is placed relatively well to meet the budgetary costs of an ageing population although some risk may emerge in the long-run. A number of measures aimed at improving the age dependency ratio and at modernising the pension and health-care systems are being implemented to improve the long-term sustainability of public finances. Nevertheless, there are risks related to the short-term costs of the pension and health-care reforms and the outstanding contingent liabilities. Securing an adequate primary surplus is essential to ensure that the public finances remain on a sustainable footing.

Table 1: Comparison of key macroeconomic and budgetary projections

		2003	2004	2005	2006	2007
Real GDP (% change)	**CP**	**9.0**	**7.0**	**7.3**	**6.6**	**6.3**
	COM	8.9	6.9	6.6	n.a.	n.a.
	PEP	*6.8*	*6.2*	*6.5*	*6.0*	*n.a.*
HICP inflation* (%)	**CP**	**-1.2**	**0.9**	**2.0**	**2.1**	**2.5**
	COM	-1.1	1.0	2.2	n.a.	n.a.
	PEP	*0.1*	*2.8*	*2.5*	*2.6*	*n.a.*
General government balance (% of GDP)	**CP**	**-1.7**	**-2.7**	**-2.5**	**-1.8**	**-1.5**
	COM	-1.7	-2.8	-2.6	n.a.	n.a.
	PEP	*-2.4*	*-2.9*	*-2.5*	*-1.8*	*n.a.*
Primary balance (% of GDP)	**CP**	**-0.4**	**-1.3**	**-1.2**	**-0.6**	**-0.4**
	COM	-0.4	-1.4	-1.3	n.a.	n.a.
	PEP	*-1.1*	*-1.6*	*-1.2*	*-0.5*	*n.a.*
Government gross debt (% of GDP)	**CP**	**21.5**	**22.4**	**22.2**	**21.4**	**21.0**
	COM	21.9	22.8	23.2	n.a.	n.a.
	PEP	*22.9*	*22.7*	*23.2*	*23.3*	*n.a.*

*CP, PEP: CPI inflation
<u>*Sources:*</u>
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecastss (COM)

1. INTRODUCTION

The Lithuanian authorities submitted the first convergence programme, covering the period 2004-2007, on 14 May 2004. The programme largely complies with the data and model structure requirements of the revised code of conduct on the content and format of stability and convergence programmes. It was drafted by the Ministry of Finance, which also co-ordinated contributions by the other Ministries and the Central Bank and was approved by the Government of Lithuania. Overall, the programme includes the set of measures stated in the budget for 2004 and is based on the same macroeconomic scenario.

The strategy for public finances presented in the programme is anchored by the key objective of "*the approximation to a cyclically balanced general government budget*". This strategy is part of an overall economic policy framework aiming at sustainable and rapid economic growth. However, the programme seems more focused on maintaining the actual deficit below 3% of GDP over the programme period. The medium-term fiscal scenario depicts an initial increase of the general government deficit from 1.7% of GDP in 2003 to 2.7% in 2004, and a decreasing trend thereafter to reach 1.5% of GDP by 2007. The expected fiscal adjustment for 2005-2007 is reflected in a steady reduction of the primary deficit after 2004, although a gradual decrease of interest expenditures will also contribute to the deficit reduction.

Following an initial increase of the general government debt by about 1% of GDP in 2004, the debt ratio is expected to progressively decrease and remain around 21% of GDP in the medium-term. Lithuania has accumulated public funds in the so-called Reserve Fund, which are to be drawn on in extreme situations and economic emergencies. The Reserve Fund is fed primarily by the Privatisation Fund and accounted for about 2.4% of GDP in April 2004.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

The medium-term macroeconomic scenario presented in the programme foresees GDP growth to remain strong, particularly in 2004 and 2005, when it is foreseen to stand at respectively 7% and 7.3%. Looking ahead, growth is expected to slow down slightly to 6.3-6.6% in 2006 and 2007, but is estimated by the national authorities to remain above potential[3]. Domestic demand is foreseen to continue to be the main driver of growth, primarily led by high investment and private consumption growth. Strong domestic demand is expected to stimulate high import growth over the programme period, while exports are also expected to continue to grow robustly in the wake of increasing external demand, high productivity gains and further trade integration. The current account deficit is foreseen to remain stable at 6% of GDP or below in the medium-term. The deflationary trend experienced in 2003 is expected to be reversed this year, to a large extent due to excise and VAT changes required by accession. Annual average inflation (CPI) is expected to reach 0.9% in 2004 and progressively pick up to 2.5% in 2007. The

[3] The programme projects a negative output gap in 2003 and 2004, when potential output growth is estimated at respectively 6% and 5.9%. From 2005 on, GDP is expected to exceed potential, which is estimated to growth at 5.7% in 2005, 5.5% in 2006 and 5.3% in 2007.

unemployment rate is expected to continue improving, declining from 12.4% in 2003 to 9.7% in 2007 (Labour Force Survey data).

The programme's macroeconomic scenario is based on the assumption that Lithuania's external economic environment will, in general, remain stable during the programme period. The external assumptions are broadly in line with the Commission Spring 2004 forecasts, particularly as regards exchange rates and growth rates of the EU and global economy. The projected Brent oil prices are broadly in line with the Commission Spring 2004 forecasts as concerns 2005, but the authorities are more optimistic for 2004 (31.1 USD/barrel by the Commission services against 28.5 USD/barrel in the programme).

The programme's macro-economic projections are based on rather favourable growth assumptions in the initial years of the programme, particularly in 2005, when GDP is foreseen to grow at 7.3%, against 6.6% projected by the Commission services. Going forward, the programme's growth rates for 2006 and 2007 appear optimistic, although not implausible, as domestic demand is expected to remain robust and the contribution of net exports to growth is expected to gradually improve after 2005, reflecting significant investment increases in previous years and competitiveness bolstering measures that enhanced export capacity.

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**
Real GDP (% change)	8.9	9.0	6.9	7.0	6.6	7.3	n.a.	6.6	n.a.	6.3
Contributions:										
- Final domestic demand	11.0	9.8	8.5	6.9	8.0	7.0	n.a.	6.4	n.a.	5.4
- Change in inventories	0.7	1.2	0.4	0.8	0.2	0.8	n.a.	0.8	n.a.	1.0
- External balance on g&s	-2.8	-2.0	-2.0	-0.7	-1.6	-0.5	n.a.	-0.7	n.a.	-0.1
Employment (% change)	1.5	2.0	1.3	0.7	1.2	1.0	n.a.	0.2	n.a.	0.2
Unemployment rate (%)*	12.7	12.4	11.5	11.3	10.7	10.3	n.a.	10.0	n.a.	9.7
HICP inflation (%)**	-1.1	-1.2	1.0	0.9	2.2	2.0	n.a.	2.1	n.a.	2.5
GDP deflator (% change)	-1.2	-0.9	1.4	0.1	2.4	2.1	n.a.	2.1	n.a.	2.7
Current account (% of GDP)	-6.1	n.a.	-6.2	n.a.	-5.9	n.a.	n.a.	n.a.	n.a.	n.a.

*COM: Eurostat harmonised unemployment definition; CP: national definition according to Labour Force Survey
**CP: CPI inflation
<u>*Sources:*</u>
Convergence programme (CP); Commission services spring 2004 forecastss (COM)

2.2. External accounts

In 2003, the current account deficit turned out to be worse than estimated by the Commission Spring 2004 forecasts and increased to some 6.9% of GDP, from 5.2% in 2002. The deterioration was largely due to a substantial increase in the negative balance of income, induced by large dividend payments of foreign companies to non-residents.

After an initial increase of the current account deficit due to the high import content of the expected surge in investment, fiscal consolidation should support more sustainable deficits in the medium-term. However, the present rapid expansion of investment and private consumption engenders uncertainty about the medium-term dynamics of the private savings-investment balance and increases the risk for higher current account imbalances. The authorities' projected rates of investment and private consumption seem particularly high and, although the foreseen levels may be achieved, they might not be fully consistent with the projected contribution of net exports to growth in 2004 and

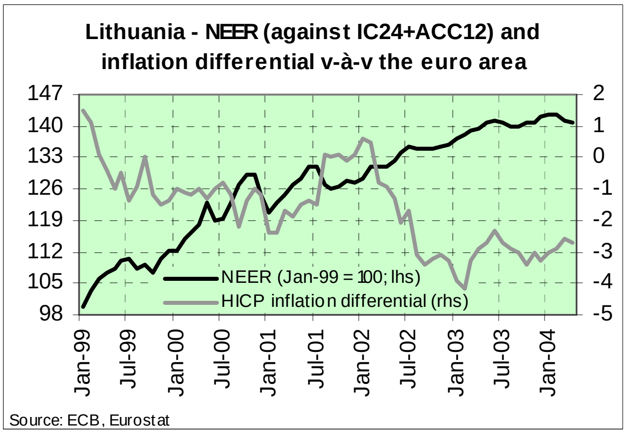
2005, which is significantly more optimistic than the Commission Spring 2004 forecasts. This raises some concerns about the programme's assumption of a stable current account deficit not exceeding 6% of GDP in the medium-term.

Lithuania's current account deficit has been primarily financed with foreign direct investment largely attracted by privatisation transactions in the last years. As the privatisation process is approaching completion, the maintenance of a sound macroeconomic policy mix and the further improvement of business and investment conditions are of critical importance to maintaining a high share of non-debt creating foreign capital inflows.

Alternative scenarios for the current account developments and the underlying domestic savings-investment balances may be considered and more attention could be paid to the analysis of the composition of capital inflows, domestic credit growth, foreign debt dynamics and associated macroeconomic and financial stability issues.

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

The main objective of the Bank of Lithuania's monetary policy is price stability, which is implemented by pursuing a fixed exchange rate policy under a currency board arrangement (CBA). Lithuania has been operating its currency board regime for more than a decade. It has proved successful as a nominal anchor for monetary policy and contributed to the remarkable disinflation process in Lithuania over the past five years and historically low interest rates.



Lithuania's inflation performance in recent years has been strongly influenced by exchange rate developments and, since 1999, average annual inflation has been below 2%. In 2003, a large effective appreciation of the litas, in combination with favourable wage and productivity developments, contributed to a negative annual rate of HICP inflation of 1.1%. In the first four months of 2004, annual deflation rates decelerated as prices for food, tobacco products, fuel and health-care picked up.

The programme expects CPI inflation to rise gradually to about 2-2.5% over the next few years. The inflation projections are broadly in line with the Commission Spring 2004 forecasts. Prices will increase due to the harmonisation of excise rates on fuel and tobacco products and the elimination of a reduced VAT rate on heating of residential housing. Other factors are expected to add pressure on prices, such as price hikes in the regulated sectors and higher prices of public transport (administered prices account for about one-fifth of the CPI basket) and possibly wage inflation in the tradable sector spilling over to the lower-productivity non-tradable sector.

The litas has experienced a nominal effective appreciation of some 50% since 1999, initially under the peg against the dollar and, since February 2002, under the peg to the euro. The programme does not make explicit references to the country's strategies on euro adoption and ERM II membership. The authorities have on several occasions, including in Lithuania's 2003 pre-accession economic programme (PEP), indicated that they intend to join the euro area soon after accession, which implies early ERM II entry. The PEP also stated that the Lithuanian authorities intend to keep all the features of the current exchange rate system, which implies maintaining the current parity and keeping the currency board arrangement as a unilateral agreement within the ERM II.

Both short-term money market rates and long-term bond yields trended down in the course of 2002 and 2003. Money market rates stabilised last year, broadly in line with developments in the euro area money market, and the short-term interest rate spread to the euro area has remained stable at around 60 basis points since end-2003. The yield spread on long-term government bonds amounted to 55-65 basis points in early 2004.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

Following a surge in the general government deficit in the aftermath of the Russian crisis, the authorities achieved a significant fiscal consolidation during the period 2000-2002. The budget deficit declined from 5.7% of GDP in 1999 to 1.4% in 2002. The government has shown a good track-record in meeting its fiscal targets, although frequent budget amendments implemented in the second half of the year have typically held back a faster deficit reduction during the strong cyclical upswing of the last two years.

Fiscal consolidation was primarily the result of expenditure adjustments, as general government revenues declined from 37.3% of GDP in 1999 to 32.4% in 2003. The decline of the tax-revenue ratio was engendered by the introduction of a number of tax benefits and exemptions from the corporate profit and personal income tax. The privatisation of public enterprises was the main factor explaining a decrease in the share of non-tax revenues to GDP, leading to a decline in dividend income, levies and interest earnings. General government expenditures as a percentage of GDP followed a steady decreasing trend from 42.9% in 1999 to 34.1% in 2003. The expenditure adjustment was concentrated on primary spending, as privatisation transactions contributed to decrease government consumption and a significant reduction of social transfers was implemented. Lower interest payments also contributed to the expenditure decrease, induced by a steady decline in interest rates. Despite the reduction of the general government deficit experienced in the period 2000-2002, the improvement masks an accumulation of government's arrears on VAT refunds to enterprises, which increased from about 0.7% of GDP in 2000 to 1.4% in 2003. The lack of information in the programme about outstanding arrears and the government's plans to repay them introduces some uncertainty for the projected budgetary targets.

Table 3: General government balance and debt, 1998-2003 (% of GDP)

	1998	1999	2000	2001	2002	2003
General government balance	-3.0	-5.6	-2.6	-2.1	-1.4	-1.7
General government gross debt	16.5	23.0	23.8	22.9	22.4	21.5
Source: *Commission services*						

In 2003, the general government deficit increased slightly to 1.7% of GDP, although undershooting the 2.4% target foreseen in the August 2003 pre-accession economic programme on the back of very strong growth. The main factors explaining the positive performance are a 0.5% of GDP higher surplus than planned by the social security funds, a corporate profit and personal income tax overshoot of 0.8% of GDP (largely due to better administration of personal income tax and the abolishment of exemptions for reinvested profits) and a better than expected budgetary balance of municipalities. This was partly offset by the implementation of an additional budget in the second half of 2003. Against the background of higher than expected revenue collection in the first half of the year, the government decided to allocate additional expenditure in this supplementary budget in July 2003. The amendments resulted in significant increases in current expenditure, mainly in the form of compensation for the loss of rouble savings[4] (about 0.4% of GDP) and agricultural subsidies (about 0.2% of GDP).

4.2. Programme overview

The key objective of the medium-term fiscal strategy defined in the programme is *"the approximation to a cyclically balanced general government budget"*. However, while the general government deficit targets are below the 3% of GDP reference value in each year, they are not consistent with a position of close-to-balance throughout the programme period. Fiscal consolidation is expected to be achieved by an increase in the GDP share of both revenues and expenditure over the period covered in the programme. The general government deficit is expected to increase significantly from 1.7% of GDP in 2003 to 2.7% in 2004, but to decrease gradually thereafter to 1.5% in 2007 (see Table 4). The medium-term fiscal scenario is in line with that outlined in the 2003 pre-accession economic programme.

The expenditure ratio is foreseen to increase by 1.8 percentage points over the same period, largely due to an increase in current expenditure. The revenue ratio is expected to increase by 2 percentage points in 2007 relative to 2003, to a large extent due to non-tax related revenues stemming from EU financial flows. The programme includes no major new policy measures to increase the tax-revenue share but projects this share to rise. This raises some concerns about a potential deceleration of growth. The general government debt has followed a steady decreasing trend from 23.8% of GDP in 2000 to 21.5% in 2003, to which privatisation proceeds, declining interest rates and lower budget deficits have largely contributed. The debt is expected to increase by nearly 1% in 2004, due to the projected increase in the government deficit, but is foreseen to stabilise at around 21% of GDP in the medium-term.

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[4] In 1997, the government decided to compensate citizens that lost part of their Soviet rouble savings in the first years of transition, when currency depreciation and hyperinflation badly hit domestic savings. The government also committed in 1995 and 1998 to restitute ownership rights or pay pecuniary compensations for real estate property confiscated during Soviet times.

Table 4: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
			General government balance		
CP	**-1.7**	**-2.7**	**-2.5**	**-1.8**	**-1.5**
COM	-1.7	-2.8	-2.6	n.a.	n.a.
PEP	*-2.4*	*-2.9*	*-2.5*	*-1.8*	*n.a.*
			General government expenditure		
CP	**34.1**	**37.6**	**37.8**	**36.8**	**35.9**
COM	35.6	37.4	37.3	n.a.	n.a.
PEP	*35.8*	*38.1*	*38.3*	*37.4*	*n.a.*
			General government revenues		
CP	**32.4**	**34.9**	**35.3**	**35.0**	**34.4**
COM	33.9	34.7	34.7	n.a.	n.a.
PEP	*33.4*	*35.2*	*35.8*	*35.6*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecastss (COM)

The deficit projections for 2004 and 2005 are broadly in line with the Commission Spring 2004 forecasts. Achieving the budgetary targets seems plausible, although the medium-term fiscal scenario is not exempt from risks. Pressures on expenditure are expected to intensify significantly during the programme period –mainly owing to high investment needs, the transition costs of the pension reform, the repayment of savings and real estate restitution obligations and higher social spending and subsidies. On the other hand, the capacity to increase tax revenues over the same period seems limited in the absence of new policy measures. This raises concerns about the budgetary impact of a potential growth slowdown. Given also the need to co-finance EU assistance, maintaining sound public finances needs to be identified as a clear priority. In this regard, the envisaged path of budgetary consolidation does not seem ambitious given the projected GDP growth rates. A faster reduction of the general government deficit if the envisaged growth rates materialise would be desirable, particularly in view of the present current account deficit and domestic demand pressures. A more rapid realisation of a close to balance budgetary position would also leave more room for the automatic stabilisers to play in case of an adverse shock.

Other factors also represent a risk for the deficit targets. In particular, the estimation of the transition costs of the pension reform is uncertain, as the choice of participation in the newly created second pillar is voluntary (the programme assumes 50% participation of the relevant groups). Furthermore, the lack of a plan for repayment of cumulated arrears on VAT refunds also introduces uncertainty to the medium-term fiscal scenario. In addition, the practice of frequent amendments to the budget in the second half of the year in response to better than planned revenue outturns introduce a pro-cyclical stance in fiscal policy and may put at risk the envisaged budgetary targets.

Table 5: Composition of the budgetary adjustment (% of GDP)

	2003	2004	2005	2006	2007	Change: 2007-2003
Revenues	32.4	34.9	35.3	35.0	34.4	**2.0**
of which:						
- Taxes & social security contributions	28.7	29.1	28.9	29.0	29.1	**0.4**
- Other (residual)	3.7	5.8	6.4	6.0	5.3	**1.6**
Expenditure	34.1	37.6	37.8	36.8	35.9	**1.8**
of which:						
- Primary expenditure	32.8	36.2	36.5	35.6	34.8	**2.0**
of which:						
Gross fixed capital formation	2.9	3.4	3.9	3.6	3.1	**0.2**
Consumption*	19.5	20.5	20.1	19.6	19.7	**0.2**
Transfers & subsidies	10.1	11.1	11.0	10.9	10.8	**0.7**
Other (residual)	0.3	1.2	1.5	1.5	1.2	**0.9**
- Interest payments	1.3	1.4	1.3	1.2	1.1	**-0.2**
Budget balance	**-1.7**	**-2.7**	**-2.5**	**-1.8**	**-1.5**	**0.2**
Primary balance	**-0.4**	**-1.3**	**-1.2**	**-0.6**	**-0.4**	**0.0**

**Consumption calculated as the difference of total expenditure and the addition of the subcomponents, as data provided for individual consumption is incomplete.*
Sources:
Convergence programme; ECFIN calculations

4.3. Targets and adjustment in 2004

The general government deficit target for 2004, at 2.7% of GDP, compares with a target of 2.9% projected in the budget for 2004 adopted in December 2003. The programme states that the revision of the 2004 deficit target responds to data adjustments to comply with ESA 95 methodology, although other key reasons seem to have affected the revision, such as the tax base increase experienced in 2003 and a marked revision of the GDP growth assumption for 2004, which was revised up from 6.2% in the 2003 PEP to 7% in the programme. The programme's statement that absorption of EU support funds causes the predicted rise in the GDP share of expenditures in 2004-2005 disregards several EU-unrelated factors that also play a role.

The widening of the deficit in 2004 reflects a sharp rise in the expenditure ratio (by 3.5% of GDP), which is less than fully offset by an increase in the revenue ratio (by 2.5% of GDP). On the expenditure side, the 2004 budget implements a marked increase in capital expenditure by 0.5% of GDP, mostly related to new investment projects co-financed by the EU. Public consumption is set to increase by about 1% of GDP, led by salary increases for public sector workers, while transfers and subsidies are foreseen to increase due to higher social welfare benefits (pensions and child benefits) and subsidies to farmers (national allocations to farmers will increase by 0.15% of GDP). Payments related to the compensation for the loss of rouble savings and the restitution of real estate assets are planned to be about the same level as in 2003 at 0.4% of GDP. A substantial increase in "other" expenditures (see table 5) mainly relates to the foreseen contribution from Lithuania to the EU budget. The transition costs of the pension reform are foreseen to account for 0.3% of GDP in 2004, although the voluntary nature of participation in the second pillar makes the estimation highly tentative.

Developments on the revenue side are largely influenced by EU structural aid. Increases in excise duties on tobacco and petrol are also expected to affect revenues positively by about 0.2% of GDP. Changes in VAT rates required by accession are expected to deliver additional revenues worth close to 0.2% of GDP, although they are estimated to be more than offset by an expected loss of 0.3% of GDP from the change in the collection procedure for VAT on imports upon EU accession.

The budgetary target for 2004 is plausible but, on the basis of the significant pressures on expenditure in 2004 and the uncertain impact of several measures described above, the risk of exceeding the 3% of GDP reference value in 2004 cannot be ruled out. The main threat to the target stems from downside macroeconomic risks. Against this background, a strict execution of the budget plans is of paramount importance to reduce the risk of breaching the reference value.

4.4. Targets and adjustment in 2005 and beyond

The programme foresees a progressive decline of the general government deficit after 2004, from 2.5% in 2005 to 1.5% in 2007. Both the revenue and expenditure ratios are expected to peak in 2005, to a large extent explained by the impact of financial flows between the EU budget and Lithuania. The programme attributes the gradual decline of both ratios after 2005 to the phasing-out of pre-accession aid and related investment.

The budgetary targets in 2005 and beyond are plausible, but worse than planned budgetary outcomes cannot be ruled out. The GDP growth projections for the period 2005-2007 seem on the high side and potentially lower-than-planned growth rates represent the main risk for the projections. The GDP growth estimate for 2005 seems particularly optimistic, and the deficit reduction in the same year does not seem ambitious enough to attain a comfortable safety margin against the 3% reference value. Furthermore, the impact of the elimination of the road tax in 2005, which is expected to result in a revenue loss of 0.5% of GDP, is a source of concern as compensatory measures to generate additional revenues are not indicated in the programme.

Regarding the years 2006 and 2007, the risk of breaching the 3% reference value is reduced provided that the 2004-2005 budgetary targets are met, but the close-to-balance requirement is unlikely to be achieved in the absence of new policy measures. Some risks stemming from expenditure overruns cannot be disregarded, like those defined in the earlier stages of this assessment, related to the pension and health reforms, the savings compensation and real estate restitution obligations and repayment of arrears on VAT refunds from the government to enterprises.

4.5. Debt ratio

The general government debt to GDP ratio has declined steadily from 23.8% in 2000 to 21.5% in 2003. The driving force behind the improvement has been the fiscal consolidation path initiated in 2000, together with more favourable borrowing conditions created by falling interest rates, privatisation proceeds and the positive valuation effect of the currency appreciation.

The programme projects an initial increase of the debt ratio in 2004 by nearly 1 percentage point, due to the increase of the general government deficit in the same year. The ratio is expected to decrease throughout the remainder of the programme horizon and stabilise at about 21% in 2007.

For the period 2003 to 2005, the debt figures provided in the programme are in line with the Commission Spring 2004 forecasts. The differences are largely explained by a recent upward revision of nominal GDP figures, which was not included in the Commission services Spring forecasts and resulted in slightly lower debt ratios.

The government's intention to reduce the volume of new debt guarantees, which accounted for about 2.6% of GDP in 2003, is welcome and its firm implementation would contribute to decreasing fiscal risks and achieving the envisaged debt levels throughout the programme period.

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	21.9	21.5	22.8	22.4	23.2	22.2	21.4	21.0
Change in debt ratio (1 = 2+3+6)	-1.0	-0.9	0.9	0.9	0.4	-0.2	-0.8	-0.4
Contributions:								
- primary deficit (2)	0.4	0.4	1.4	1.3	1.3	1.2	0.6	0.4
- snow-ball effect (3 = 4+5)	-0.4	-0.3	-0.3	-0.0	-0.6	-0.7	-0.6	-0.7
- interest expenditure (4)	1.3	1.3	1.4	1.4	1.3	1.3	1.2	1.1
- nominal GDP growth (5)	-1.7	-1.6	-1.7	-1.4	-1.9	-2.0	-1.8	-1.8
- stock-flow adjustment (6)	-1.0	-1.0	-0.2	-0.4	-0.3	-0.7	-0.8	-0.1

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth

Sources:
Convergence programme (CP); Commission services Spring 2004 forecasts (COM); ECFIN calculations

5. THE QUALITY OF THE PUBLIC FINANCES

Lithuania's fiscal consolidation strategy is based on an increase of the GDP share of both revenues and expenditure over the period covered in the programme. Although the revenue and expenditure ratios decline from a relative peak reached in 2005, they are both foreseen to stand above the levels of 2003 in the medium-term.

On the expenditure side, the increase compared to 2003 is partly due to the implementation of reforms that aim at guaranteeing the sustainability of the public finances in the long-term (pension and health reform, see section 6), together with other factors (among which the government repayments of savings compensations and real estate restitution). Relatively high expenditure increases related to these factors seem unavoidable, but has also to be seen in the light of the relatively low expenditure ratio in Lithuania. Efficient prioritisation of expenditure would leave more room for public investment to increase if necessary. Public gross fixed capital formation is projected to amount to 3.1% of GDP in 2007, up by 0.2 percentage points relative to 2003, which seems relatively low for a catching-up economy with large investment needs over the programme horizon.

On the revenue side, the increase is largely based on an increase in EU transfers and, to a significantly lower extent, to a 0.4% of GDP increase in the tax revenues in 2007 relative to 2003. Given the relatively low tax base, a more ambitious increase of revenue through tackling the problems of undeclared income and inefficient tax collection and administration together with additional measures to compensate for the impact of the road tax elimination would better support the durability of the adjustment.

There is a need to accompany the increases in expenditure with reforms designed to ensure that resources are used and allocated efficiently. In this regard, the Lithuanian government has made significant efforts to improve the budgetary procedures, such as the formulation of expenditure norms or the development of tools to improve expenditure control of municipalities, but a rapid implementation of planned actions is desirable. In particular, the transition to programme-based budgeting, the restructuring of general government expenditures (taking account of the sizeable outstanding fiscal obligations) and the improvement of the management of the municipal finances and the healthcare system would highly contribute to supporting the achievement of the budgetary targets and ensuring the durability of the fiscal adjustment.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The programme contains a section on the sustainability of public finances. It includes demographic and macroeconomic assumptions as well as projections for public expenditures on pensions and health-care until 2050.

The current demographic situation in Lithuania is characterised by a low and falling fertility rate (1.24 in 2002), a relatively low old-age dependency ratio, increasing life expectancy and negative net migration. While presently the problem of ageing is not as serious as in the rest of Europe, the projected dynamics of these demographic factors may raise concern for the long-term sustainability of public finances. In order to counter the future adverse demographic developments, the Lithuanian authorities have been aiming at increasing the birth rate by introducing a number of measures in the form of welfare benefits and social guarantees and privileges (increase in child benefits, introduction of tax-deductible interests paid for housing, increase in maternity-paternity benefits). In addition, net emigration is being addressed by granting exiles and their descendants who return to Lithuania a benefit package including one-off settlement advantages, compensation of expenses related to vocational training and favourable housing conditions.

In order to curtail the budgetary implications of an ageing population, the Lithuanian authorities have designed a number of measures to be undertaken in the programme period. Apart from parametric changes to the pay-as-you-go pillar (e.g. increase in the retirement age) and measures aimed at increasing employment, particularly of the older population (retraining or acquisition of new skills for the unemployed), a thorough pension reform was started in 2004 with the introduction of a mandatory privately funded pension scheme with voluntary participation. Concerning the health care system, restructuring of the health-care institutions is being undertaken according to the Health Care Institutions Restructuring Strategy, adopted by the government in 2003. The foreseen changes are *inter alia* aimed at improving effectiveness and efficiency of the system as well as the coverage and the quality of the health care services, which should, according to the programme projections, result in constant health care expenditures as a percentage of GDP over the entire projection period. This appears, however, overly optimistic given the projected demographic developments in the future.

The programme expects the overall increase in age-related expenditures of 1.7% of GDP between 2008 and 2050 to result only from the projected growth of pension expenditures, as the programme does not foresee any changes in the level of the health care expenditures. Projections on other relevant age-related expenditure items such as child benefits, which may increase according to the underlying assumptions on future fertility rates, do not feature in the programme. Besides a very moderate increase in projected pension expenditures, it has to be noted that government debt is currently low, at 21.5% of GDP in 2003, and is to stabilise at this level by the end of the programme period in accordance with the planned budgetary consolidation. Therefore, according to the projections in the programme, Lithuania appears to be relatively well placed to meet the budgetary costs of an ageing population. However, some risks may emerge stemming from a re-direction of a part of social security contributions from the first pillar to the second pension pillar and from outstanding contingent liabilities.

Summing up, a number of measures aimed at improving demographic prospects and at modernising the pension system are being implemented to improve the long-term sustainability of public finances. Lithuania is placed relatively well to meet the budgetary costs of an ageing population, provided the key fiscal policy objective of achieving a cyclically balanced budget and the outlined structural reforms are attained. Nevertheless, the costs of the pension and heath-care reforms and the outstanding contingent liabilities should be monitored carefully.

* * *

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Table 1. Growth and associated factors

	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	9.0	7.0	7.3	6.6	6.3
GDP *level* at *current* market prices, SKK bn.	55,737	59,712	65,447	71,215	77,705
GDP deflator	-0.93	0.13	2.14	2.09	2.66
HICP change	-1.2	0.9	2.0	2.1	2.5
Employment growth	2.0	0.7	1.0	0.2	0.2
Labour productivity growth	6.6	6.5	6.2	6.4	4.6
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	11.0	6.1	7.8	5.8	5.7
2. Government consumption expenditure	5.7	7.0	-1.0	4.0	4.0
3. Gross fixed capital formation	11.4	11.3	13.7	11.3	8.0
4. Changes in inventories and net acquisition of valuables as a % of GDP	1.2	0.8	0.8	0.8	1.0
5. Exports of goods and services	6.0	10.8	9.6	8.4	7.5
6. Imports of goods and services	8.8	10.7	9.4	8.5	6.9
Contribution to GDP growth					
7. Final domestic demand (1+2+3)	10.97	7.67	7.82	7.24	6.40
8. Change in inventories and net acquisition of valuables (=4)	1.2	0.8	0.8	0.8	1.0
9. External balance of goods and services (5-6)	-2.01	-0.68	-0.51	-0.66	-0.12

Table 2. General government budgetary developments

% of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
Net lending by sub-sectors					
1. General government	-1.7	-2.7	-2.5	-1.8	-1.5
2. Central government	-2.2	-2.8	-2.6	-1.9	-1.6
3. State government	--	--	--	--	--
4. Local government	0.03	0.05	0.02	0.02	0.02
5. Social security funds	0.5	0.1	0.1	0.1	0.1
General government					
6. Total receipts	32.4	34.9	35.3	35.0	34.4
7. Total expenditures	34.1	37.6	37.8	36.7	35.9
8. Budget balance	-1.7	-2.7	-2.5	-1.7	-1.5
9. Net interest payments	0.4	0.6	0.6	0.5	0.5
10. Primary balance	-0.4	-1.3	-1.2	-0.6	-0.4
Components of revenues					
11. Taxes	20.0	20.4	20.2	20.3	20.4
12. Social contributions	8.7	8.7	8.7	8.7	8.7
13. Interest income	0.9	0.8	0.7	0.7	0.6
14. Other	2.8	4.9	5.7	5.4	4.8
15. Total receipts	32.4	34.9	35.3	35.0	34.4
Components of expenditures					
16. Collective consumption	7.9	7.6	7.0	6.7	6.5
17. Social transfers in kind	1.4	1.5	1.5	1.5	1.5
18. Social transfers other than in kind	9.3	9.6	9.4	9.3	9.2
19. Interest payments	1.3	1.4	1.3	1.2	1.1
20. Subsidies	0.8	1.5	1.6	1.6	1.6
21. Gross fixed capital formation	2.9	3.4	3.9	3.6	3.1
22. Other	0.3	1.2	1.5	1.5	1.2
23. Total expenditures	34.1	37.6	37.8	36.7	35.9

Table 3. General government debt developments

% of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
Gross debt level	21.5	22.4	22.2	21.4	21.0
Change in gross debt	-0.9	0.9	-0.2	-0.8	-0.4
Contributions to change in gross debt					
Primary balance	0.4	1.3	1.2	0.6	0.4
Interest payments	1.3	1.4	1.3	1.2	1.1
Nominal GDP growth	-1.7	-1.6	-2.1	-1.9	-1.9
Other factors influencing the debt ratio	-0.9	-0.2	-0.6	-0.6	0.1
Of which: Privatisation receipts	-1.5	-0.7	-0.8	-0.2	-0.2
p.m. implicit interest rate on debt	5.5	5.2	5.3	5.4	5.4

Table 4. Cyclical developments

% of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
1. GDP growth at constant prices	9.0	7.0	7.3	6.6	6.3
2. Actual balance	-1.7	-2.7	-2.5	-1.8	-1.5
3. Interest payments	-1.3	-1.4	-1.3	-1.2	-1.1
4. Potential GDP growth	6.0	5.9	5.7	5.5	5.3
5. Output gap	-1.4	-0.4	1.1	2.1	3.1
6. Cyclical budgetary component	-0.1	0.0	0.1	0.2	0.3
7. Cyclically-adjusted balance (2-6)	-1.5	-2.7	-2.6	-2.0	-1.8
8. Cyclically-adjusted primary balance (7-3)	-0.3	-1.3	-1.3	-0.9	-0.8

Table 5. Divergence from previous update

% of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
GDP growth					
Previous update	6.8	6.2	6.5	6.0	--
Latest update	9.0	7.0	7.3	6.6	6.3
Difference	2.2	0.8	0.8	0.6	--
Actual budget balance					
Previous update	-2.4	-2.9	-2.5	-1.8	--
Latest update	-1.7	-2.7	-2.5	-1.7	-1.5
Difference	0.7	0.2	0.0	0.1	--
Gross debt levels					
Previous update	22.9	22.7	23.2	23.3	--
Latest update	21.5	22.4	22.2	21.4	21.0
Difference	-1.4	-0.3	-1.0	-1.9	--

Table 6. Long-term sustainability of public finances

% of GDP	2004	2005	2010	2020	2030	2050
Total expenditure	38.4	37.8	37.4	37.4	37.4	37.4
Old age pensions [1]	5.3	5.3	5.3	5.3	6.0	7.0
Health care (including care for the elderly)	4.6	4.6	4.6	4.6	4.6	4.6
Interest payments	1.7	1.3	1.1	0.9	0.7	0.5
Total revenues	36.0	35.3	37.4	37.4	37.4	37.4
Of which: from pension contributions	5.1	5.3	6.1	6.2	5.4	4.4
National pension fund assets (if any)	--	0.8	N/A	N/A	N/A	N/A
Assumptions						
Labour productivity growth	8.3	6.2	5.0	4.7	4.5	4.0
Real GDP growth	3.9	7.3	6.1	4.2	3.5	2.7
Participation rate males (aged 20-64)	82.1	83.3	88.2	89.0	90.0	90.2
Participation rates females (aged 20-64)	74.2	74.5	76.7	79.0	79.5	80.0
Total participation rates (aged 20-64)	77.9	78.4	82.0	83.9	84.6	85.0
Unemployment rate	16.4	10.3	9.2	7.4	6.3	6.0

(1) On the assumption that the increase of the pension age to 65 years will start in 2010.

Table 7. Basic assumptions

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)	2.4	2.3	2.5	2.9	3.5
Long-term interest rate (annual average)	5.3	5.0	5.3	5.7	6.1
United States: short-term (three-month money market)					
United States: long term (10-year government bonds)					
USD/€ exchange rate (annual average) [1]	1.13	1.25	1.25	1.25	1.25
Nominal effective exchange rate (euro area)					
Nominal effective exchange rate (EU)					
SKK/€ exchange rate (annual average)					
World GDP growth, excluding EU					
United States, GDP growth					
Japan, GDP growth					
EU-15 GDP growth	0.8	2.0	2.4	2.4	2.4
Growth of relevant foreign markets					
World import volumes, excluding EU	7.3	9.7	8.5	8.5	8.5
World import prices (goods, in USD)					
Oil prices (Brent, USD/barrel) [2]	28.5	28.5	28.5	28.5	28.5
Non-oil commodity prices (in USD)					

(1) Technical assumption.

(2) The upper limit of OPEC's price corridor.